Trisanto Limited – Outline Business Case

On behalf of Arun District Council

Draft Report v1
December 2021

Contents

1. Executive Summary

1.1. Introduction

Savills have been appointed to produce an outline business plan for its wholly owned housing company, Trisanto Limited (TL) in order to establish the options available to Arun District Council (ADC, the Council) in deciding its future.

Since its incorporation Trisanto Limited has not commenced trading and therefore has been dormant, which is the driver for this business case to establish if the Council should dissolve the company or invest in its growth.

This business case focuses on:

- Understanding what the Council wants to achieve from Trisanto
- What service offering should Trisanto provide
- The resources required to progress the continuation of Trisanto
- Any alternatives to the original business case for the delivery of homes through Trisanto
- What circumstances have changed since Trisanto's inception that may affect its future
- Is there potential for future financial viability?

1.2. Our Approach

We have covered three key areas of enquiry as part of this review:

- Strategy – in understanding what the Council wishes to deliver and achieve through operating Trisanto. This was established through a series of discussion sessions with key stakeholders within the Council.
- Options – from the discussions and our experience elsewhere to identify the potential options available for Trisanto and to assess the advantages and disadvantages of these with a risk assessment, and drawing on viability analyses, our recommended way forward for the Council and the company. This is reinforced throughout our report with examples of other local authority approaches.
- Financial – to understand the potential viability of Trisanto, considering land opportunities, financing available, state aid (subsidy control) and resourcing.

After considering feedback from the discussion sessions, and our experiences elsewhere in carrying out similar reviews, we have established that in order to deliver more homes and higher levels of home ownership, there are three options able to be considered:

1. Development Company

This is where Trisanto remains incorporated and focuses purely on developing and selling market sale properties and delivering 30% affordable homes as required under planning obligations – with, in this case, these properties being acquired by the Council into its Housing Revenue Account (HRA). Due to a lack of council-owned developable land, Trisanto would need to be enabled to acquire land in competition from and with developers in the open market.

2. Development Company & Subsidiary Local Housing Company

This is where Trisanto would remain a development company and acquire land to develop. 30% of homes would be acquired within the HRA for the affordable element, whereas the remaining properties would be split or solely sold to a newly formed subsidiary housing company to be rented at either market or intermediate rent levels. Any remaining balance of homes would be sold on the open market.

3. Subsidiary Local Housing Company

In place of acquiring land and developing directly, Trisanto would acquire properties from a range of sources to hold and let at either market or intermediate levels.

1.3. Viability

We have modelled a range of scenarios with the overall conclusion as follows:

1. Development Company

Given the lack of developable land ownership within the Council, we modelled an exemplar site that has since been sold that could have delivered 80 properties. Whilst the site appraisal demonstrated that the scheme was viable, the resulting land value that could be afforded by Trisanto Limited would face extreme competition from other medium to large size developers, which benefit from economies of scale in their operations and existing supply chains. Furthermore, Trisanto would have to resource, via financing from the Council, any pre-planning work prior to bidding for land, and this investment would be at risk if an acquisition did not take place.

2. Development Company & Subsidiary Local Housing Company

We modelled a group structure where the exemplar site would be developed within one company (either Trisanto or a new subsidiary), making a return to the Council and then a new company acquiring the properties for letting at market rent levels. Due to the small stockholding of rented units, the property holding company was not felt to be financially viable.

3. Subsidiary Local Housing Company

We produced a plan that showed how acquiring 454 units through the open market and directly from developers from forthcoming sites could be potentially viable. These properties could be let at either market or intermediate levels. Based on our modelling it showed a viable long-term position, providing annual returns to the Council of c£1.3million driven primarily by a lending premium on interest rates. However, the viability of the plan is very sensitive to adverse market conditions.

1.4. The Way Forward

As a result of the stakeholder sessions and the viability testing option 3 is felt to be the only direction that the Council could consider Trisanto taking into a further a fuller Business Case stage.

Our modelling highlights that for option 3, whilst sustainable in the asset values grow as debt is repaid, debt repayment would take longer than 50 years on a revolving credit basis. There are a number of factors that need, therefore, to be considered in this context:

- In the short to medium term, the financial projections show that no allocation for debt repayment could be made; in fact there may be a requirement for additional borrowing post acquisition. Therefore a loan repayment strategy would be required and agreed between the Council and Trisanto that would not financially adversely impact the Council
- We have made prudent assumptions as to taxation exposure – the Council would need to take specific tax advice to assess whether viability can be improved as a result of taxation liabilities, particularly in respect of group borrowing
- A minimum number of units would have to be acquired to ensure coverage of overhead costs
- Research should be commissioned to understand the demand for market and intermediate rental properties in the district and the key geographical areas, tenure and property sizes on which to focus.

Whilst the above factors require external support, the Council could carry out its own initial market testing by opening up discussions with both active developers and estate agents in the area to understand if there would be interest in selling to Trisanto.

After the above are satisfied, Trisanto could seek to start trading and commission support for its acquisition programme both externally and in the light of capitalisation by the Council.

Alternatively, the Council could decide to dissolve the company as the development options carry much risk in respect of viability and long-term returns.

2. Introduction and the Brief

2.1. Introduction

Savills have been appointed to produce an outline business plan for Trisanto Limited (TL) in order to establish the options available to Arun District Council in deciding its future.

TL was established in 2016 following an initial business case to generate income from market sale properties but also with a view to provide market rental homes and assist ADC in the delivery of 30% affordable homes on the sites developed.

The initial business case focused on three sites, two of which were not in the ownership of ADC, with the one site that was owned delivering an initial 8 homes.

Following agreement of the business case, the company was incorporated with ADC being the sole shareholder. Financial resources were identified for both working capital and set up costs but never transferred to Trisanto.

Due to a lack of staffing resource there has never been any activity in respect of trawling the market for land opportunities and this was backed up by no 'in-house' development appraisal expertise, nor any specific form of gateway decision making for progressing TL. This was exacerbated by a lack of ADC owned land that could be developed at scale. Apart from the initial company formation documentation, there has been no further development of key documents such as service level agreements and formal loan arrangements with ADC.

Therefore TL has remained a dormant company will nil financial returns filed and there is currently one director recorded, an officer of ADC.

Since 2018, ADC's Housing Revenue Account (HRA) has benefited from increased financial flexibilities with the abolition of the debt cap; this allows for additional borrowing to facilitate the development of affordable homes. The Council is focusing the HRA on developing on its own land, which is primarily limited to small scale garage sites.

2.2. The Brief

A summary of the brief is set out below. The business case is focused on:

- Understanding what ADC wants to achieve from TL
- What service offering should TL provide
- The resources required to progress and the continuation of TL
- Any alternatives to the original business case for the delivery of homes through TL
- What circumstances have changed since TL's inception that may affect its future
- Is there potential for financial viability?

2.3. Our Approach

We have covered three key areas of enquiry as part of this review:

- Strategy – in understanding what the Council wishes to deliver and achieve through operating Trisanto. This was established through a series of discussion sessions with key stakeholders within the Council.
- Options – from the discussions and our experience elsewhere to identify the potential options available for Trisanto and to assess the advantages and disadvantages of these with a risk assessment, and drawing on viability analyses, our recommended way forward for the Council and the company. This is reinforced throughout our report with examples of other local authority approaches.
- Financial – to understand the potential viability of Trisanto, considering land opportunities, financing available, state aid (subsidy control) and resourcing.

Strategy

We undertook individual stakeholder discussion sessions during October with the following:

- Leader of the Council
- Leader of the Opposition
- Director of Place
- Director of Services
- Interim Group Head for Corporate Support & Representation from Internal Audit

We thank those who kindly provided their time. Rather than detailing individual feedback from our range of questions we have summarised the key messages and thoughts from the sessions as below.

Lack of Land Availability:

Currently ADC owns only two General Fund sites that offer any degree of development potential. One is a small piece of land used for leisure purposes and the other in the form of a row of commercial properties with flats above, which would likely require redevelopment. The HRA does have a small land holding through redevelopment of garage sites but this will be utilised for development of 100% affordable housing. There will be a review of sheltered housing sites that could offer potential for redevelopment, but likely that this would also be delivered through the HRA. Therefore from both members and officers perspectives, it is clear that there is no real land availability in the ownership of ADC that could be utilised for development and therefore the only course of action for TL would be to purchase from the open market in competition with developers. There has been one instance where a bid was considered for land owned by West Sussex County Council but the land was sold to BoKlok who manufacture homes off-site to a standard specification.

Lack of Internal Resources & Capacity:

As already identified, TL has not progressed due to a lack of resource and expertise within ADC and an unwillingness to procure external support given future uncertainty. There are concerns that the medium-term position for the ADC General Fund is facing shortfalls and that any expenditure or finance provide to TL without certain return would be difficult to justify. Currently there is no development expertise and some stakeholders were aware of the difficulty of recruiting resources due to competition and capacity within the current market. If any options were considered that required specialist private landlord services, this would be difficult to resource within the HRA staffing compliment.

Market Intervention:

One of the reasons that local authorities venture into development and housing companies is to intervene within the market. This may be to increase the current standards within the private rented sector through competition. Other intervention measures are in respect of regeneration or developing land that has been rejected by private developers on the grounds of viability. These were not considered real issues for ADC although could be considered in respect of regeneration activities within Bognor Regis. It was thought that there was a shortage of private rented sector properties available. It was felt by some that the focus by developers seemed to be more for the 'executive' style homes rather than focusing on smaller, more affordable homes for first time buyers.

Interest in Intermediate Rented products:

The HRA currently focuses on delivering affordable rented homes with the option to provide shared ownership properties. This provides homes for those at the top of ADC's housing waiting list. This means that those lower down the list but unable to afford private market rented or sale properties are not provided for. There was an interest in assessing the option for delivering this type of tenure, as other local authorities have decided to do, due to the difficulties faced by first time buyers within the district. The district is also seen as area with an increasing older population and any changes would assist in balancing the demographics.

Financial Benefits:

Other than market intervention the core reason for instigating a development or housing company is for the financial rewards it offers. Dependent on the option, the financial returns are either short-term through capital receipts and one-off dividends or an annual return through premiums on interest and potential dividends from property cashflow surpluses. The focus for ADC would be the latter where annual support is provided to the General Fund to assist with offsetting future deficits. However, whatever option is selected for TL, it should only be on a sound financial and profitable basis.

<u>Options</u>

After considering the feedback from the discussion sessions and our experiences elsewhere in carrying out option appraisals and outline business cases to deliver more homes and ownership we have arrived at three options that can be considered:

1. Development Company

   This is where TL remains incorporated and focuses purely on developing and selling market sale properties and delivering the 30% affordable homes planning obligation with, in this case, the affordable homes acquired by the Council into its HRA. Land would have to be acquired in competition from and with developers from the open market.

2. Development Company & Subsidiary Local Housing Company

   This is where TL would remain a development company and acquire land to develop. 30% of homes would be acquired by the HRA for the affordable element whereas the remaining properties are split or solely sold to a newly formed subsidiary housing company to be rented at either market or intermediate levels. Any remaining balance of homes would be sold on the open market.

3. Subsidiary Local Housing Company

   In place of acquiring land and developing TL would acquire properties from a range of sources to let at either market or intermediate levels.

These three options are considered in greater detail below.

Financial

For each of the options we have researched the market to identify potential land and/or acquisition opportunities in order to provide a baseline for an outline financial business case and to test viability. We have assessed both sale and rental markets for the specific areas within the district in order to test viability, but also to compare the potential returns for ADC. As above, the financial modelling has been carried out for each option and results presented within the individual sections below, with sensitivity analysis and stress testing carried out where applicable.

3. Option 1: Development Company

3.1. Introduction

This option is where TL carries out the development of Council-owned or acquired sites for selling homes on to the private market and the affordable units to the HRA or a Registered Provider. Such a company is also known, described or defined as a Devco.

The establishment of local authority trading and housing delivery companies is a very well-trodden path, originally conceived by stock owning authorities due to the restrictions on the Housing Revenue Account with the primary focus on delivering affordable schemes. Research undertaken by UCL into local authority direct delivery was updated in April 2021 (from the previous iteration in July 2019). It provides an excellent evidence base for the emerging companies sub-sector with the following key headlines:

- 83% (an increase of 5%) of English local authorities have some form of housing company, be it a
  - Development Company
  - Property Company
  - Local Housing Company
  - Special Purpose Vehicle for Joint Ventures

- The previous report stated:
  - 23% of the 22% without a company are actively exploring the options
  - 119 new companies have been established since January 2018
  - Variety of tenure diversification:
    - 43% Affordable Rent
    - 23% Social Rent
    - 10% Intermediate (sub-market)
    - 16% Market Sale
    - 8% Market Rent.

From our experience the drivers for setting up companies have primarily been as follows:

- Increase housing supply – across all tenures
- Diversify housing offer – making interventions in the market to stimulate or provide housing
- Quality and design standards
- Control and influence around what is delivered
- Bring forward sites that would not otherwise be brought forward
- Act as an exemplar landlord for market rent housing
- Deliver financial returns to the Council.

These are not dissimilar from some of those points identified from our sessions with stakeholders at ADC, and this should offer reassurance from the approach other local authorities are taking.

From our research and knowledge of development companies there are success stories, those that have struggled, or continue to struggle to gain traction, and those that are dormant or being closed down. It is difficult to determine exactly what is happening with the majority of Devco's given that they operate in a commercial environment and therefore official plans are not always published.

An exemplar for a development company would be Wokingham Council's Loddon Homes who were an early development company which has gradually built its pipeline in an area of high value. It is part of a wider group that delivers affordable and social care homes for the Council.

However, in terms of companies that have not been able to deliver their original objectives Croydon Council's development company Brick by Brick is facing closure once its 23 sites have been delivered following an external audit report on poor financial performance and controls having a negative impact upon the Council's own finances. Following the publicity of this case Council's such as Merton have reconsidered moving forward with developing through Merantun and closed the company. It is likely that others may follow or reconsider their options, such as joint ventures. It should be noted that there are more examples of authorities actually delivering new homes than not, as identified within the UCL report.

By creating a Devco, ADC could receive an upfront receipt for land (in its ownership) put forward for the scheme or in exchange for equity within the company. Alternatively, as there is little land owned by ADC, this would have to be procured from the open market in competition with other developers. The Devco would contract a developer/contractor to build out the site but would be responsible for the sale of the units for both the open market sale units but also the affordable units to the HRA (or Registered Provider) or (per option 2 below) a Local Housing Company.

At no point would the Devco hold properties for rent and therefore the financial benefits for ADC will be in the development profit for the sites. As ADC will be in indirect control of the schemes, there is control over the tenure mix between market sale and affordable units balanced with the generation of development profit. However, this will in part be dependent on the level of sale receipts for the affordable units, which in some options will be beyond the control of ADC if an external RP were to purchase via a competitive process. However, for ADC, the HRA is likely to acquire the affordable units.

ADC would make a premium on the development finance on-lent to the Devco, although this would only be through the duration of the development of the sites. This arises from the low cost of borrowing but lending into the Devco at a commercial rate, a requirement of state aid/subsidy rules.

3.2. Legal & Financial Structures

As TL has already been officially formed there are no further considerations required other than the governance arrangements which depend on a variety of issues and in the vast majority of cases the Devco board will be composed of officers and (if thought necessary) independent non-executive directors.

The board then reports to a supervisory shareholding group consisting of members in order to provide a greater strategic control and direction rather than the more day to day responsibilities of the board.

We have also found that a Gateway Board (or equivalent) is established by an authority in order to decide how the land assets are addressed and who develops the sites i.e. for sale, development through the HRA or its Devco. This may also be used for land acquisitions.

The financing would be provided by ADC through its General Fund (via its Capital Financing Requirement or CFR), but charged at commercial levels. There has been much publicity in respect of some local authorities using the benefiting from the lower than commercial borrowing rates through the Public Work Loans Board (PWLB) for the purposes of income generation. It has been the past practice for commercial assets to be acquired outside of a local authority area utilising funding at low interest rates. Recent guidance from CIPFA and Treasury has now reduced this practice and such borrowing facilities are no longer available for the purchase of yield.

However, the guidance allows borrowing for the purposes of providing housing within the local authority area.

All companies still need to be EU State Aid or Subsidy Control, its replacement post Brexit, compliant. If properties being built are for market sale then the Devco would need to be established on a fully commercial basis (ensuring funding terms are the equivalent of what a private developer might be able to obtain in the marketplace – for example, interest rates are at market levels, maximum loan to value with the associated potential for equity funding). The actual rules in respect of Subsidy Control are currently being formulated, though we anticipate little change from the State Aid regime.

3.3. Procurement Options

The Devco will not be subject to the Public Contracts Regulations 2015 if it does not fall within the definition of a "body governed by public law." Bodies governed by public law have all of the following characteristics:

- They are established for the specific purpose of meeting needs in the general interest, not having an industrial or commercial character;
- They have a legal personality; and
- They have any of the following characteristics:
  - they are financed, for the most part, by the State, regional or local authorities, or by other bodies governed by public law;
  - they are subject to management supervision by those authorities or bodies; or
  - they have an administrative, managerial or supervisory board, more than half of whose members are appointed by the State, regional or local authorities, or by other bodies governed by public law.

The key point therefore, is determining whether the Devco is a "body governed by public law" and whether it has "commercial character".

The Devco cannot be said to have a "commercial character" unless it is free to operate as a commercial company would do so and without direct control from the Council (particularly over its operational activities.)

If ADC require direct control, the Devco is likely to be classified as a "body governed by public law" and therefore subject to the procurement requirements.

If the Devco were not subject to the procurement requirements then it can procure services as it sees fit, subject only to any controls ADC wish to impose as shareholder.

The practice of reaffirming commitment to a Devco, the Council would need to procure a robust process of due diligence that concentrates on:

- The strategic business planning of the company.
- The financial management and risk strategy of the newly formed company.
- Governance and commercial arrangements to enable the Devco to operate in a commercial environment to deliver value for money.

With the Devco established, this would be followed by the procurement and forming of contractual arrangements under the following types of procurement routes for the construction of new build:

- Design and Build contract – appointment of a house building contractor to deliver the pre-construction and delivery of new build.
- Set up of a framework agreement to supply housing.
- A development agreement incorporating a design and build contract arrangements.
- A strategic partnership with an institutionally funded private sector investor/developer of housing, under a partnership/development agreement.

In other procurement routes contained within the Devco, such as development agreements, the design and construction costs can be managed legally through a design and build contract, or lump sum contract arrangements. These forms of agreement set out the roles and obligations of each party including obligations around design responsibility and cost management. This includes trigger agreements around performance and financial management of the new build process. Such triggers could place the Council under obligations and risk if not managed and robustly tested.

Importantly, development agreements enable the Devco to immediately acquire the required skills and expertise to deliver its house building ambitions, while also imposing risks and restricted controls on design standards etc.

3.4. Staffing Resource

For the purposes of the following appraisal we have assumed that there will be no 'in-house' support within ADC to proceed with any development appraisals, land acquisitions and subsequent overall development management.

For the purposes of the following appraisal we have assumed the following would be recruited by TL (Devco):

- Client Role (Part-Time) for overall management throughout the duration
- Provision for scheme viability appraisal (outline assumptions) to arrive at land price
- Legal advice in respect prospective land purchase

All of these costs, provisionally c£100,000, would be unrecoverable if a bid for land was unsuccessful and that ADC may ultimately bear the risk as it would provide the upfront working capital finance for these costs.

In addition to the above we have assumed that the following would also be outsourced with appropriate cost provision for:

- Planning Support and application
- Architects (pre and post planning)
- Engineering and Landscape reporting
- Market research
- Employers Agent
- Fees of 8% for Development Management (monitored on behalf of TL by the above role)
- Marketing & Selling Agency
- Conveyancing.

There will also be operational costs to run TL (Devco) that will be also outsourced which includes:

- Accountancy Support
- IT support
- External Audit
- Ongoing consultancy and legal support

ADC does have the opportunity to provide some of the above support services 'in-house' and charge to TL (Devco) rather than outsourcing but is very much dependent on capacity and expertise within the various teams. Any such charge would result in an additional financial benefit to the General Fund of ADC.

3.5. Development Cost Assumptions

As there is no site availability in ownership of ADC, in order to produce an exemplar viability appraisal for this option we have used the land at the South of Littlehampton Academy to model. Whilst this site has now been sold by West Sussex County Council it provides the opportunity to demonstrate the likely land value that TL could potentially have bid for. We did carry out a high-level trawl of sites of those with potential for development but the majority have already been purchased.

In terms of this site it was originally appraised that 80 homes could be potentially built on the land as identified below:

Table 3.1 Exemplar Development Site – Property Make Up

Category	Sq Mtr Size	Total No	Affordable Element
2 Bedroom Terraced House	75	16	8
2 Bedroom Semi-Detached House	79	23	8
3 Bedroom Terraced House	92.5	37	8
3 Bedroom Semi-Detached House	120	4	

The post-Brexit period and the issues arising from Covid, have resulted in fluctuations in costs and delays in materials and in some instances labour supply. This continues with recovery from the Covid pandemic with increasing shortages in both supplies and labour.

Therefore, we have taken a standardised approach to costing the development costs per site as follows:

Table 3.2 Build Cost Assumptions

Category	Rate	Commentary
Direct Build Cost	£1,650 per Sq Mtr (£1,700 flats)	Equates to £143k per property
Architect Fees	2.5% of Development Cost	Outsourced
Planning Costs	£1,000 per Unit	
Engineering Surveys & Fees	1.5% of Development Cost	
Employers Agent	2.0% of Development Cost	To cover external costs including cost consultancy and site management
Remediation Costs	£100,000	High level assumption
Parking & Landscaping	£450,000	
Utilities	£200,000	Electric/Water only
Contingency	5.0% of total Development Cost	To cover for Unknown Factors
CIL/s106 Contributions	Nil	Assumed not applicable
Marketing & Legal Costs	2% of Market Value	Applies to for sale units only
Project Management Fees	8%	Outsourced

Existing medium to larger sized housebuilders will be able to build at lower costs on the basis of existing supply chains, defined house types and built to different standards in respect of style, size and possibly energy efficiency. We have demonstrated the potential impact of this when comparing potential land values.

In order to determine the gross development value for the development we have assumed the following values

Table 3.3 Market Values on Exemplar Site

Category	Market Value
2 Bedroom Flat	£230,000
2 Bedroom House	£275,000
3 Bedroom House	£335,000
4 Bedroom House	£355,000

In assessing the value to which the HRA (or RP) could pay for the affordable properties we have modelled using both social and affordable rents and a standard set of operating costs we have assumed the 70% of open market value would be appropriate. This sits at the mid-point between using the two levels of rent for viability for the HRA.

3.6. Financial Analysis

To finance the development, consideration has to be given as to how this would be facilitated. The options are 100% loan financing or loan and equity investment.

Given that normally a private developer will not be able to access 100% loan finance in order to deliver a scheme, equity investment is usually required. This would also assist the Devco complying with State Aid (or its eventual replacement Subsidy Control).

Equity investment could be provided to TL (Devco) by ADC by either a cash injection, transferred land or a combination of both. Given that that ADC has no land offering for this development any equity investment will need to be in the form of cash.

We have assumed that 30% of total development costs (pre-financing), totalling £3.768million would be provided by ADC directly to TL (Devco). ADC would fund this via the options of either using cash balances, uncommitted capital reserves or short-term borrowing. If borrowing, then ADC would incur interest charges for the amount borrowed but would also need to factor in the impact of making Minimum Revenue Provision (MRP) contributions. Borrowing for the purposes of equity is allowable but only for a maximum period of 20 years, which results in an MRP of 5% pa, although the impact of this is mitigated by the borrowing in this instance being over a relatively short (development) period.

The equity provided to TL (Devco) would be repaid at the conclusion of the development and would obviously be at risk if there was insufficient profit, after tax, to repay this. Any equity returned could be utilised in the repayment of attributable debt by the Council. We have projected that short-term borrowing costs for the equity investment in this exemplar scheme would result in a cost to ADC of c£0.127million.

Development finance would need to be on the basis of commercial rates with regards to compliance with State Aid (or its eventual replacement Subsidy Control). Given that a proportion of the homes are affordable and that 30% equity is proposed a blended rate of 5% is suggested.

It is important to note that the development finance supplied would be considered inter-group borrowing between ADC and TL (Devco) in respect of the calculation of Corporation Tax. The rules that could apply are capped interest deductions on related party loans at 30% of EBITDA (earnings before interest, tax, depreciation and amortisation) or where the level of interest deduction claimed exceeds £2million. If interest charges within one year, on loans which are considered to be from a related party, were (for example) £2.3million, only £2million would be included within the Corporation Tax computation to reduce tax liability, and the balance of £0.3million would not. We are aware of circumstances where specific arrangements have been made with HMRC whereby such loan facilities and subsequent interest charges can be fully accounted but advise that specialist tax advice is sought.

Working capital finance via an additional loan facility will also be required to cover the costs of operational and overhead costs. This is repaid upon completion of the development at a rate of 3.5%.

VAT: Most of the development costs will be recoverable from the VAT payable but in some instances such as white goods provided within the homes, and operational costs bought into the company, this will not be possible.

Corporation Tax: Surpluses will be liable for taxation at the prevailing rate, currently 19% but rising to 25% in 2023 on annual profits greater than £250,000.

The table below shows the results of the development appraisal modelling as set out above. In order to achieve industry standard returns, we have assessed that a bid of **£2.7million** could be made for the land.

Table 3.4 Development Company Option - Financial Appraisal – Exemplar Site

Trisanto Limited (Devco)	TOTAL
Sales Income	**£21,804,000**
Development Costs	**£17,565,248**
Marketing Costs	**£342,000**
Gross Profit	**£3,896,752**
Development Financing Costs	**£339,343**
Gross Profit (After Financing)	**£3,557,409**
Overheads	**£499,425**
Working Capital Interest	£15,987
Net Profit (Pre-Tax)	**£3,057,983**
Corporation Tax	**£760,499**
Net Profit (Post Tax)	**£2,297,484**
Profit on Gross Development Value	**20.3%**
Profit on Cost	**19.5%**
INTERNAL RATE OF RETURN	**23.6%**

** Development costs include relevant taxes (eg SDLT)*

Using this appraisal ADC would benefit from:

- **£2.297million** dividend (at scheme completion)
- **£0.237million** premium on the on-lending (assuming cost of borrowing at 1.5%)

This would be set against potential financing costs for the equity investment of **£0.127million**.

Note that if build costs increased by 20%, the potential dividend would reduce to **£0.167million**, but with an increased interest premium of **£0.297million**.

Any further changes in assumptions such as reductions in house prices or higher build costs (above the 20%) against those modelled above would result in no profit being achieved and equity investment therefore being at risk.

Private Developer Approach

As detailed earlier, given that TL (Devco) would be in competition with private medium to large sized developers which may benefit from economies of scale. Therefore we have modelled, by way of demonstration, the viability modelling for the same site but with different build cost assumption and operating costs.

Table 3.5 Private Developer - Financial Appraisal – Exemplar Site

	TOTAL
Sales Income	**£21,132,000**
Development Costs	**£16,981,242**
Marketing Costs	**£342,000**
Gross Profit	**£3,808,758**
Development Financing Costs	**£432,490**
Gross Profit (After Financing)	**£3,376,267**
Overheads	**£263,664**
Working Capital Interest	£3,533
Net Profit (Pre-Tax)	**£3,112,603**
Corporation Tax	**£777,268**
Net Profit (Post Tax)	**£2,335,336**
Profit on Gross Development Value	**19.9%**
Profit on Cost	**19.0%**
INTERNAL RATE OF RETURN	**21.3%**

In order to meet industry standard returns we estimate that the potential land value could be **£3.9million**, some £1.2million greater than TL (Devco) could potentially offer.

For comparison, if TL (Devco) was to bid £3.9million for the land, in order to be competitive, the resulting dividend payable to ADC would be **£1.259million** and interest premium of **£0.312million**, an overall reduction in return of **£0.963million**. Increased costs place additional risks in terms of profitability and return of equity if build costs were to increase or market values decrease.

3.7. Meeting Objectives Assessment

The matrix below shows an assessment of how TL (Devco) could meet our assessment of ADC's objectives.

Table 3.6 TL (Devco) Option - Objective Matrix

Objective	Option Meets objective	Commentary
Provide a Long-Term Income Stream	No	One-off dividend per development site and interest premium
Ability to deliver the type of houses needed	Partly	Based only on viability
Potential to provide Intermediate rented properties	No	Only market sale and affordable homes – intermediate rented properties may be able to form part of the affordable homes obligation
Provide a sound profitable basis	No	Considered high risk as land purchases in competition with developers with higher buying power. This option involves less risk if ADC utilised its own land

3.8. Advantages & Disadvantages

This section of the report identifies the advantages and disadvantages (or strengths and weaknesses) of developing within TL (Devco).

Table 3.7: TL (Devco) Option - Advantages and Disadvantages

Advantages	Disadvantages
The Council will make a return (premium) on the loans it makes to the Devco and potential dividends it receives from each development site profit	No long-term financial benefits to the Council
The ability for the Council to be actively involved in land purchase and regeneration by acting as lead developer.	Potential implications for corporation tax, VAT, stamp duty land tax and State Aid (Subsidy Control)
	Upfront investment required in investing in land search, appraisals and legal costs which would be unrecoverable to ADC if land acquisition is unsuccessful.
	The Council is exposed (indirectly through scheme viability) to land acquisition values and build cost risks but also future viability that could require subsidy from the General Fund

3.9. Key Risks and Mitigation

The table below identifies the key risks specifically associated with the focused Devco option. These risks will only emerge once the Devco commences trading and development starts.

Table 3.8: TL (Devco) Option – Risks

Risk	Likelihood	Measures and mitigation
The financial assumptions used to model the outputs prove to be materially different in practice	Medium	The assumptions will be undertaken with external advice and are comparable with other similar products. Variations would be appraised by the TL (Devco) board for it to instigate compensatory changes elsewhere in the plan or to monitor the situation if considered marginal.
Higher than anticipated build costs	High	This would be monitored and has a significant impact to the viability of TL (Devco). Contracts could be let on the basis of risk transfer to the building contractors.
Tax issues have not been clearly identified and modelled	Medium	Scheme appraisals will assume an allowance for payment of non-recoverable VAT. Advice needs to be sought as part of the set-up process to minimise future implications. Corporation Tax will be payable on development profits.
A legal challenge is made with regards to State Aid (Subsidy Control)	Low	Expert opinion should be sought to ensure that the terms and interest rates offered on the loans by the Council are considered reasonable.
Properties prove difficult to sell or prices fall	Medium	It is acknowledged that there is demand for homes for sale within the district. Certain loans would have to be refinanced and properties could be let for a short period as market or affordable rent and then sold.
Ability to recruit staff to deliver the developments	High	TL (Devco) would have to procure services that could not be provided by ADC, which given current demand and capacity within the sector could be difficult.
Perception and reputation	Low	The Council's role as a housebuilder and operator would need to be considered in the context of ensuring correct branding and marketing strategy.
Government intervention	Low	The creation of a Devco is accepted as a way of accelerating delivery.

4. Option 2. Development Company & Local Housing Company Subsidiary (market & intermediate homes)

4.1. Introduction

This option would result in TL forming a subsidy and/or Group Structure. Another type of wholly-owned trading company is a Local Housing Company (LHC) – a description utilised to cover a company which develops and/or acquires and then holds housing for rent in the long-term. This can be at social, affordable, intermediate and/or full market rent levels. The tenure mix can either be in one company as a whole or separate Local Housing Companies defined for each tenure type. Many authorities delivering both affordable and market rented housing elect to do so in two separate companies given the different objectives and commercial implications associated with each.

Therefore this option proposes that TL (Devco) is developed and a new TL (LHC) is established, with the existing TL organisation being renamed or branded. TL (Devco) would acquire land and develop properties for market sale and or market rent with the balance being the affordable element for the HRA (or RP) to acquire.

This option de-risks selling properties on the open market, given that TL (LHC) could acquire a chosen proportion of them.

There is the option for ADC to consider:

- Considering an alternative intermediate offer where the affordable properties are let at, for example, LHA levels
- Properties are let at Market Rent levels.

There is, theoretically, more flexibility around the setting of rents in a LHC (compared to the HRA). The Rent Standard which controls rents within the HRA/Registered Provider sector does not apply, but when looking to rents at affordable levels the Local Housing Allowance (LHA) provides the best benchmark - plus it ensures the rent would be fully covered by Housing Benefit/Universal Credit.

By having a mix of tenures in terms of rental products, TL (LHC) can determine, from the perspective of financial viability, to maximise the number of properties let at intermediate and market rents. The different levels of rents and the associated impact on financial viability are explored as part of the outline appraisal below.

4.2. Legal & Financial Structures

The set up and structure for TL (LHC) would see little difference to that compared to TL (Devco), although the Board make up may wish to defer from development specialist members in place of housing management.

Financing of the LHC would be by the usual routes:

- Borrowing could be via Public Works Loans board (PWLB) at very low current interest rates undertaken within the Prudential Code framework of the Council, on-lent to the LHC with or without a risk premium; a formal loan agreement would be established.
- The Council's own revenue and capital reserves.

ADC will need to secure independent treasury advice in respect of the financing of these loans, particularly in relation to Minimum Revenue Provision (MRP). However, as a general rule, it is for the Council's s151 officer to determine whether the application of a MRP against borrowing is prudent, and if so at what level and on what basis.

It is not unusual for local authorities to input equity into a LHC. Whilst not a necessity for intermediate housing in terms of compliance with similar organisations, it may be prudent if private rental market letting is going to be a key activity for TL (LHC).

As a wholly owned company any '1-4-1' right to buy receipts arising from the HRA may not be gifted to the LHC for the intermediate rented properties. Homes England grant could only be achieved if TL (LHC) were to be registered as a Registered Provider with the Regulator of Social Housing, which is generally held to have little advantage over the properties being in the HRA and would extend the period of time before development could commence.

TL (LHC) will have additional overhead costs to enable it to operate as a separate legal entity and these will be factored into the business case. Furthermore, all costs will incur irrecoverable VAT on the delivery of landlord (i.e. VAT-exempt) services, and any profits will be liable to Corporation Tax. Again, these are factored into the business case; appropriate detailed and specific tax advice should be sought in due course.

It is difficult to determine the success stories of LHCs given that many are in their early stages of development and have only filed micro accounts to date which do not provide for a full picture of trading. With the Local Housing Companies we have been involved with the majority have based their plans on acquisition from the open market, although the trend has been to see more direct development. There can be loss-making periods in the early years until numbers of properties have been built if payments are made on account to the development company (effectively financing forward funding of elements of the development).

4.3. Procurement Options

The development of the properties would be resourced through TL (Devco).

However, the landlord function to manage the rental properties, would need to be sought and for the early years we would anticipate this being sourced externally.

4.4. Staffing Resource

As TL (Devco) would have the resource in place for the development, all that would be required, apart from the support services required (detailed below), would be a small clienting function for the landlord management services procured, the default would be for landlord services to provide services under contract or Service Agreement to TL (LHC).

There will also be operational costs to run TL (LHC) that will be also outsourced which includes:

- Accountancy Support
- IT support
- External Audit
- Ongoing consultancy and legal support
- Annual Valuations
- Operational & Board Insurances.

As set out above, ADC does have the opportunity to provide some of the above support services 'in-house' and charge to TL (LHC) rather than outsourcing but is very much dependent on capacity and expertise within the various teams.

4.5. Financial Analysis

We have considered three alternative approaches for modelling the LHC option:

- Option 1: 100% of non-affordable units are acquired and let at market rents
- Option 2: After the deduction of the affordable units 50% are sold on the open market and 50% let at market rent levels
- Option 3: After the deduction of affordable units 100% at Intermediate Rent levels.

Along with the costs for overheads assumed there will be operational costs to consider and these are detailed below.

Table 4.1: TL (LHC) Option 2 – Operational Assumptions

Category	Market /Intermediate Rent
Management Fee	7% of net rent (+ VAT)
Buildings Insurance	£200 per unit
Voids Allowance	2%
Bad Debt Provision	0.5%
Revenue Repairs Year 2+	£500 per unit (+ VAT)
Provision for Major Repairs Year 11+	£1,040 per unit (+VAT)

The rent levels that we have used in the modelling are detailed below.

Table 4.2: TL (LHC) Option 2 – Rent Assumptions

Category	Market Rent (per month)	LHA (per week/month)
2 Bed Flat	£925	£184.11/£798
2 Bed House	£995	£184.11/£798
3 Bed House	£1,200	£223.23/£967
4 Bed House	£1,375	£287.67/£1,246

Option 1 – 100% Private Rented Market

A commercial rate of 3.75% has been assumed for on-lending to TL (LHC), given that the rents will be at market levels.

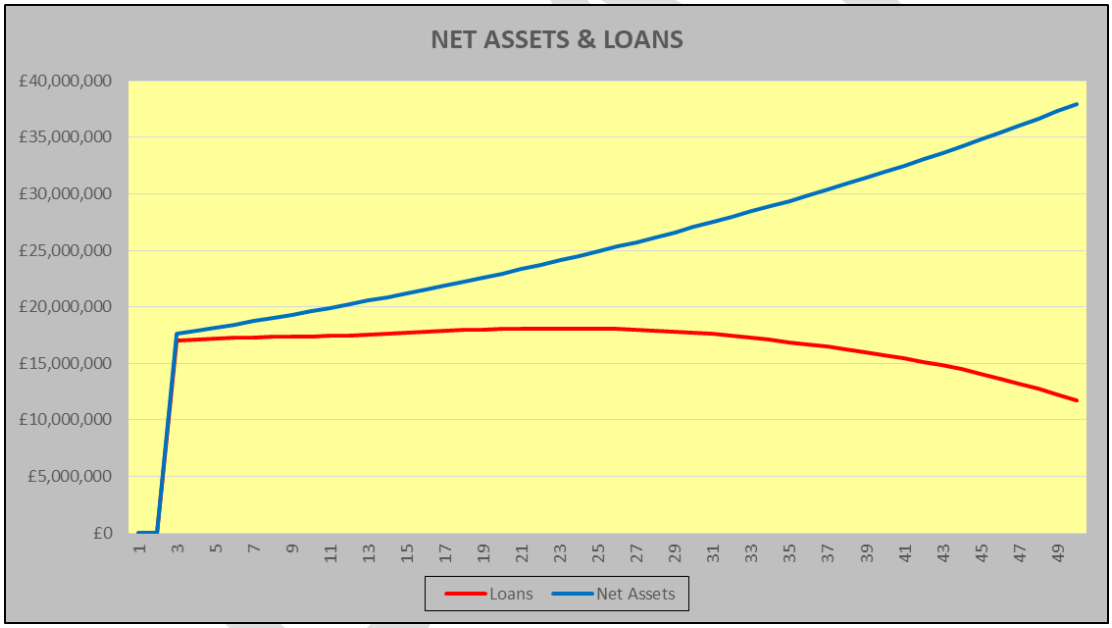
In the first instance we have assumed that TL (LHC) will acquire the units at 100% of open market value. Therefore the TL (Devco) profit (and dividend payment) is broadly similar but does increase to **£1.506million** on account that there will be no marketing fees, due to no market sales.

The premium (the difference between the cost and on-lending rate) on the loans remains unchanged.

In order to test the viability of TL (LHC) we have modelled the on-lending as a 'revolver' loan. Loan balances increase or reduce based on surplus or negative cashflows in order to demonstrate over what period borrowing could be repaid. The chart below shows this position.

We have assumed a flat rate for inflation of 2% for all income and costs, applied from year 2 onwards.

Chart 4.1: TL (LHC) – Forecast Loan Requirement & Net Asset Values – Blended Acquisition Approach 100% Market Rents



The red line represents the loan balances based on an interest rate of 3.75%. Following initial borrowing of £17.0million, borrowing peaks at £18.1million in year 24 then reduces to £11.7million in year 50. If using the final years' trajectory, the loans could be repaid by year c69.

The blue line represents the net asset value of the properties after tax and assuming house price inflation of 2%.

Whilst the loans balances are below the asset value for all years, the prospect of needing to borrow to continue to operate does not present a viable position.

In addition, due to the nature of the 'revolver' loan, all surpluses are utilised for debt repayment and not dividends payable to ADC. The 'revolver' loan does not factor in the potential implications for MRP, as discussed above. Given that no significant levels of debt can be repaid in this option it is not considered any further at this stage.

The return to the Council, based on a borrowing cost of 2.75%, would provide an annual return on interest premium of c£0.173million per annum.

As the annual interest charges within the plan for TL fall within the £2million cap for party related loans, the full interest charge is therefore included with the Corporation Tax computation.

Option 2 – 50% Market Sale 50% Private Rented Market

Given the outcome of the modelling above we have not shown the impact of reducing the number of private rented properties given that due to economies of scale for the coverage of overhead costs the borrowing increases year on-year.

Option 3 – 100% Intermediate Rented Market

Replacing the market rental values with those of the intermediate values will have an adverse impact to the viability. This can be offset by reducing the interest rate to 3.25% due to the sub-market nature of the lettings. By reducing the acquisition value to 90% of open market value further improves the position, but leaves TL (Devco) making a £0.218million profit and in-year borrowing still required by TL (LHC).

Summary

The initial appraisal for all three schemes demonstrates that long-term viability is challenging to achieve. A key factor in this is the coverage of overheads of c£0.112m per annum with only a rental holding of 56 units. In order to achieve greater viability it would take at least a 200 stock holding from TL (Devco) to repay any borrowing within a 50-year time period.

4.6. Meeting Objectives Assessment

The matrix below shows an assessment of how the LHC meets the requirements of ADC and to enable a direct comparison in order to assist with recommending an option.

Table 4.2 Option 2: TL (Devco) & TL (LHC) - Objective Matrix

Objective	Option Meets objective	Commentary
Ability to deliver the type of houses needed	Partly	Based only on viability within TL (Devco)
Potential to provide Intermediate rented properties	Partly	Whilst TL (LHC) could deliver intermediate rented properties the viability assessment on acquisitions from TL (Devco) appear financially unviable

Objective	Option Meets objective	Commentary
Provide a sound profitable basis	No	Considered high risk as land purchases in competition with developers with higher buying power for TL (Devco). For TL (LHC) the proposition appears unviable based on the assumptions made.

4.7. Advantages & Disadvantages

In conjunction with the above financial analysis, we have identified the advantages and disadvantages (or strengths and weaknesses) of establishing a LHC in addition to TL (Devco).

Table 4.3 Option 2: TL (Devco) & TL (LHC) - Advantages and Disadvantages

Advantages	Disadvantages
The Council will make a return (premium) on the loans it makes to both the Devco and LHC and potential dividends they would receive	There are additional set up costs involved. VAT is payable on operating costs for the LHC.
Ability to flip rent levels for properties not classified as affordable between intermediate and full market rent.	Additional administration with separate accounts required (that then possibly consolidate with the Council)
Market level rented properties could be sold or let as intermediate or affordable rented properties at a later stage	There may be an indirect impact on the Council being able to borrow on other projects through constraints on prudential borrowing – as a result of development and investment lending running concurrently.
There is the option to have different tenures on the sites depending on the market assessment	The Council has no experience of letting within the private sector and will need to contract with a suitable provider.

4.8. Key Risks and Mitigation

The table below identifies the key risks specifically associated with the combination of a Devco and LHC. The majority of risks will only emerge once the LHC commences trading and development starts.

Table 4.4 Option 2: TL (Devco) & TL (LHC) – risks

Risk	Likelihood	Measures and mitigation
The financial assumptions used to model the outputs prove to materially different in practice	Medium	The assumptions will be undertaken with external advice and are comparable with other similar products. Variations would be appraised by the LHC board for it to instigate compensatory changes elsewhere in the plan or to monitor the situation if considered marginal
Higher than anticipated build costs	High	This would be monitored as it could have a significant impact to the viability of the LHC. Contracts could be let on the basis of risk transfer to the builders

Risk	Likelihood	Measures and mitigation
Rising interest rates	Medium	Assumed increases will be built into the business case. In periods of higher inflation and interest rises living rents would be expected to increase. Fixed rate borrowing could also be undertaken.
Tax issues have not been clearly identified and modelled	Medium	Scheme appraisals will assume an allowance for payment of non-recoverable VAT. Advice needs to be sought as part of the set-up process to minimise future implications. Corporation Tax will be payable on annual profits.
A legal challenge is made with regards to State Aid (Subsidy Control)	Low	Expert opinion could be sought to ensure that the terms and interest rates offered on the loans by the Council are considered reasonable.
Properties prove difficult to let	Low	Demand through the waiting list shows that this should not be problematic for intermediate units. The ability to switch properties to market levels and vice-versa
Impact on staffing if the LHC is wound up or does not progress	Low	The LHC would not employ anyone directly and any services that could not be provided by the Council internally would be outsourced. Any support from the Council would use existing resources so there are no risks to current staff. Some support is anticipated to be outsourced within the modelling and this could be expanded
Perception and reputation	Low	The Council's role as an operator in the market sale and private letting sector would need to be considered in the context of ensuring correct branding and marketing strategy
Demand for certain tenures changes	Low	The balance of the properties, be it market rent or market sale, could be varied voluntarily for a short or medium term, though the impact to the business plan would be need to be assessed

5. Option 3. Acquisition of Properties for Market & Intermediate Rent

5.1. Introduction

The first two options have focused on delivering new properties through development. Another option, and one that has been undertaken by a number of councils, is the route of acquisition. As with option 2, such stock holding companies are recognised as Local Housing Companies (LHCs).

This option focuses on TL concentrating on acquisition as a LHC.

Exemplars for a Local Housing Company include South Cambridgeshire's Ermine Street Housing, Wokingham Housing and Reading Homes. It is noted and acknowledged in the most recent UCL report that the abolition of the HRA debt cap has led many authorities to rethink their options, particularly where affordable housing was a key driver.

The routes for acquisition will be straightforward though may involve competition from other providers:

- Purchasing from properties on the open market via estate agencies or direct marketing
- Acquire directly from housing developers (from those that would be offered to the market)
- Review local auctions for repossessions and seek to fully refurbish (where necessary)
- Small annual transfers from the HRA (limited to 5 per year).

Before any acquisition price is agreed, the individual or group of properties can be appraised without the risk of development costs. Trisanto could establish a hurdle/appraisal process whereby if an appraisal does not meet a pre-agreed series of hurdles for financial performance (for example Net Present Value, payback, Internal Rate of Return), then an acquisition would not progress.

5.2. Legal & Financial Structures

The structure is in place for TL already, although a review of the articles of association may be necessary to ensure long-term property hold is covered.

Financially, it will be as described in section 2, with ADC providing loan facilities to TL. These are discussed further in the financial analysis section below.

5.3. Procurement Options

There will be no direct procurement required in respect of the acquisitions. However, some support services will be provided externally and require a form of tendering, but these would not be subject to the usual rules that apply to ADC.

5.4. Staffing Resource

Discussions with local agents and developers already identified on sites within the district could commence immediately to identify if there are the opportunities modelled within this outline business case. We would expect to be carried out by officers already in place.

If, based on discussions and further testing of the business case, the decision was made to progress this we would assume that TL would recruit an acquisition officer. This has been costed into the business case for a period of 5 years, the duration of modelled acquisitions.

As before, operational and support costs, including recharges for client monitoring have been modelled into the plan.

5.5. Financial Analysis

We have made a range of assumptions in order to produce an outline business case, which of course can vary, but at least sets out a potential position.

We have focused only on two area of acquisitions, where we think are the areas where the greatest volume could be achieved. For auction acquisitions, this is very market-dependent and still volatile given the past couple of years. We have also assumed that this stage that ADC will want to retain as much stock as possible within its HRA and therefore no transfers have been modelled.

Acquisitions from forthcoming developments

We have reviewed the sites identified for development within the next 5 years within the district and concentrated on the most populated areas with a view for demand for rental properties. Given that planning is either in its early stages or masterplans being consulted on we have had to assume the type of properties acquired. Within the modelling we have assumed the following split of house to be acquired:

- 2 Bed 35%
- 3 Bed 50%
- 4 Bed 15%.

For each of the development areas we have assumed that 10% of the sites could be acquired, allowing for 30% that will be made affordable, leaving 60% for the developer to market for sale.

There is a risk with changes to planning and also Government policy that may well affect the percentage that could be acquired, First Homes, being the obvious challenge although the full implications are yet to play out.

The table below lays out the areas of the sites that we have researched, the potential overall development numbers and then what we have assumed that could be acquired. In total, we estimate at least that 294 homes could be acquired for letting at market rent levels.

Table 5.1 Option 3: TL (LHC acquisition) – Potential Development Sites Numbers

Area	No. of Sites	Total Homes	Year	No. Acq'd	2 Bed	3 Bed	4 Bed
Pangham South	2	465	2023	46	16	23	7
Pangham North	2	580	2024	58	20	29	9
West Bersted	1	225	2023	22	8	11	3
Fontwell	1	400	2023	40	14	20	6
Yapton	1	250	2025	26	9	13	4
Angmering North	2	700	2025	71	25	35	11
Climping	1	300	2024	31	11	15	5
TOTAL		**2,920**		**294**	**103**	**146**	**45**

We have carried out research on both market sales and rental values for the area, noting that these could be impacted with the new developments within the area. The values assumed are as follows.

Table 5.2 Option 3: TL (LHC acquisition) – Potential Development Site Values

£	Market Sales Values			Market Rental Values (per month)		
	2 Bed	3 Bed	4 Bed	2 Bed	3 Bed	4 Bed
Pangham South	325,000	390,000	500,000	1,000	1,250	1,500
Pangham North	325,000	390,000	500,000	1,000	1,250	1,500
West Bersted	300,000	330,000	400,000	1,100	1,350	1,600
Fontwell	320,000	380,000	420,000	1,100	1,400	1,550
Yapton	340,000	390,000	470,000	950	1,350	1,450
Angmering North	320,000	350,000	415,000	1,150	1,350	1,500
Climping	320,000	350,000	415,000	1,150	1,350	1,500

In terms of acquisition values we have assumed a **5% discount** on the above values, given that TL would make bulk purchases, provide certainty and savings for the developer in respect of marketing. The modelling assumes acquisition at completion, therefore there are no payments in advance. If this was required then a further discount on the acquisition value would be needed in order to cover the financing cost for TL.

We have factored in SDLT rates at current levels with the 3% premium for landlords. An additional £500 per property has been included for legal fees, again discounted due to an assumption of bulk purchases.

Given that these properties are new and market values initially inflated to reflect this, all lettings are assumed to be at market levels with no intermediate rents modelled.

Operational costs are the same as assumed in table 4.1.

Table 5.3 Option 3: TL (LHC acquisition) – Potential Development Site Financial Performance

%	Gross Yield		
	2 Bed	3 Bed	4 Bed
Pangham South	3.9	4.0	3.8
Pangham North	3.9	4.0	3.8
West Bersted	4.6	5.2	5.1
Fontwell	4.3	4.7	4.7
Yapton	3.5	4.4	3.9
Angmering North	4.5	4.9	4.6
Climping	4.5	4.9	4.6

This table provides a demonstration of the gross yields for each area and type of house that has modelled and how it varies.

In terms of targeting a gross yield, the costs of finance and operational costs must be factored in to the appraisal.

Acquisitions from the Open Market

Put simply, these will be acquisitions either from properties being marketed through local estate agents or through direct marketing campaigns managed by TL.

We have centred on two population areas, Bognor Regis and Littlehampton. Furthermore, we have split the acquisitions equally between low-range values and mid-range values.

Within the modelling we have assumed the following acquisitions, each year, for a 5-year period.

Table 5.4 Option 3: TL (LHC acquisition) – Open Market Acquisition Numbers pa

Area	Point	2 Bed	3 Bed	4Bed
Bognor Regis	Low	3	4	1
	Mid	3	4	1
Little Hampton	Low	3	4	1
	Mid	3	4	1
Total		12	16	4

Therefore, over a period of 5 years a total of 160 property acquisitions have been modelled from the open market.

In terms of the market values modelled the tale below lays out those assumed and the rental values modelled. Properties acquired at the low range of the market will be let at Local Housing Allowance (LHA) levels which we have deemed at intermediate as between affordable and market levels.

By setting rents at LHA levels any intermediate rent would be fully covered by Universal Credit, if tenant needed to rely on this.

Table 5.5 Option 3: TL (LHC acquisition) – Open Market Acquisition Values

£		Market Values			Rents Assumed		
Area	**Point**	**2 Bed**	**3 Bed**	**4Bed**	**2 Bed**	**3 Bed**	**4Bed**
Bognor Regis	Low	200,000	230,000	280,000	798	967	1,250
	Mid	230,000	250,000	320,000	1,100	1,250	1,400
Littlehampton	Low	215,000	240,000	300,000	798	967	1,250
	Mid	240,000	270,000	335,000	1,100	1,350	1,450

In terms of acquisition values we have assumed a **5% discount** on the above values, given that TL would provide certainty. The modelling assumes acquisition at completion. We have factored an average initial £1,750 improvement cost for each property to ensure it will be at a lettable standard.

We have factored in SDLT rates at current levels with the 3% premium for landlords. An additional £750 per property has been included for legal fees.

Operational costs are as modelled for the new development properties.

5.6 Option 3: TL (LHC acquisition) – Open Market Acquisitions Performance

%		Gross Yield		
Area	**Point**	**2 Bed**	**3 Bed**	**4Bed**
Bognor Regis	Low	4.7	4.9	5.3
	Mid	5.6	5.9	5.1
Little Hampton	Low	4.4	4.7	4.9
	Mid	5.4	5.9	5.1

This table shows that the intermediate rents provide for a lower gross yield and that Bognor Regis performs slightly better.

Financial Projections

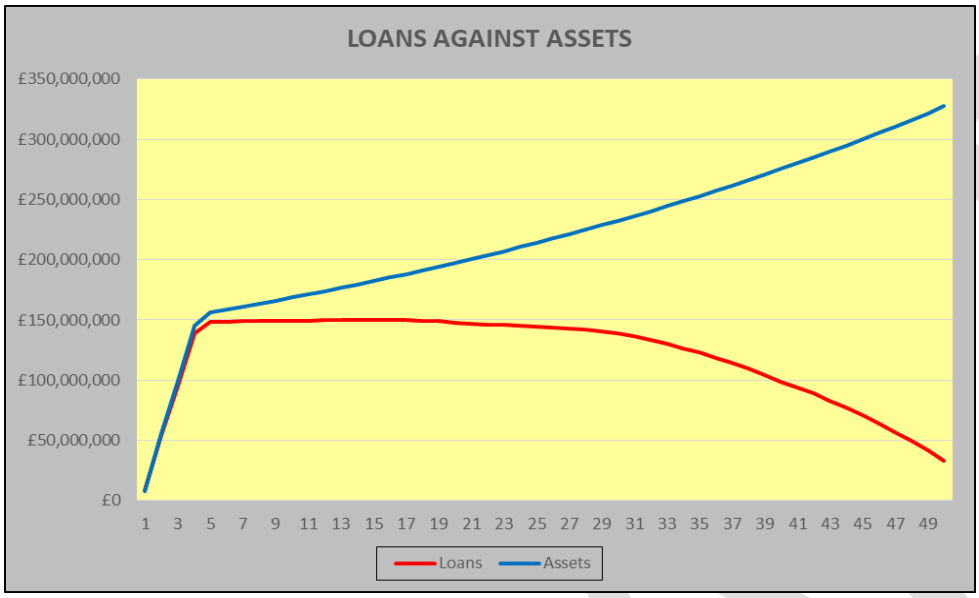
We have modelled the combined acquisition of 454 properties over 5 years using the various assumptions of purchase prices and rent levels as set out above, using appropriate levels of future overhead costs of c£0.074million per annum and a financing cost of **3.66%** (which takes into consideration that 18% of the properties will be at intermediate level at 3.25% and the balance at a rate of 3.75%).

Corporation Tax is a key factor within the outline business case. As profits will be greater than £250,000 a rate of 25% is applied. In addition as interest charged to TL is greater than £2million on an annual basis, we have applied the related-party rule that only £2million of interest is allowable in the Corporation Tax computation.

As before, we have modelled on the basis of a 'revolver' facility that draws financing as required and utilises surpluses to repay this in order to demonstrate viability.

The forecast 'revolver' facility is shown in the graph below, with an assumption of annual inflation for all costs, rents and market values.

Chart 5.1 – TL (LHC) - Forecast Loan Requirement & Net Asset Values – Blended Acquisition Approach



The chart demonstrates gradual borrowing up to an initial £148.2million and then peaks at £150.2million and begins to reduce post year 16 of the plan. At all times, asset values remain higher than the loan balances.

The loan balances are forecast to be c£33.3million in year 50, but following the reduction trajectory could be fully repaid by year 54, within a 50-year window of the final acquisitions.

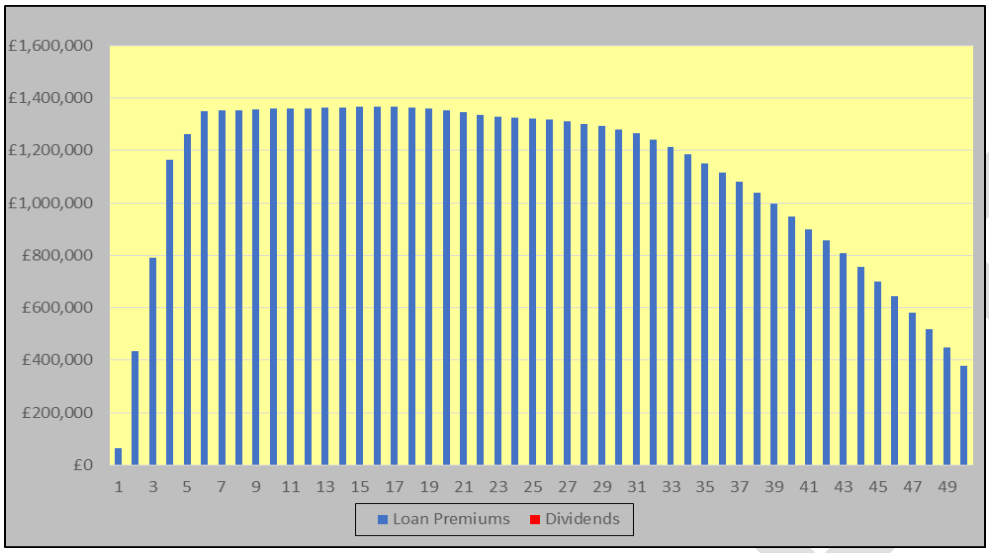
This approach assumes that no dividends will be payable during this period as surpluses are used to repay debt.

The loan projection is not ideal in that borrowing is required for the period from year 6 to 16 in order to cover interest and operating costs. Whilst TL would still be considered a 'going-concern' in that ADC would continue to provide finance support, this would cause issues if any loan repayments were required during this phase.

A key constraint on the viability is the inability to include 100% of the financing costs within the Corporation Tax computation. For example in the 6th year of the plan (post all acquisitions) the interest charge is £5.425million. With only £2million interest allowable in the computation, the resulting Corporation tax actually payable for the year (for operations) is £0.992million, whereas if 100% of the interest was allowable the amount due would reduce to £0.135million. The full impact of this over the duration of the plan is demonstrated in the sensitivity table below.

We have assumed that the actual cost of borrowing to the ADC for the on-lending to TL is 2.75% set against the 3.66% that would be charged. This results in an annual premium on the interest charges, for the benefit of ADC. This annual values, based on the above 'revolver' loan profile, are shown in the graph below.

Chart 5.2 – TL (LHC) Forecast Loan Premiums For ADC – Blended Acquisition Approach



This equates to an average £1.36million per annum in the mid-term of the plan.

Fixed Term Loan Repayments

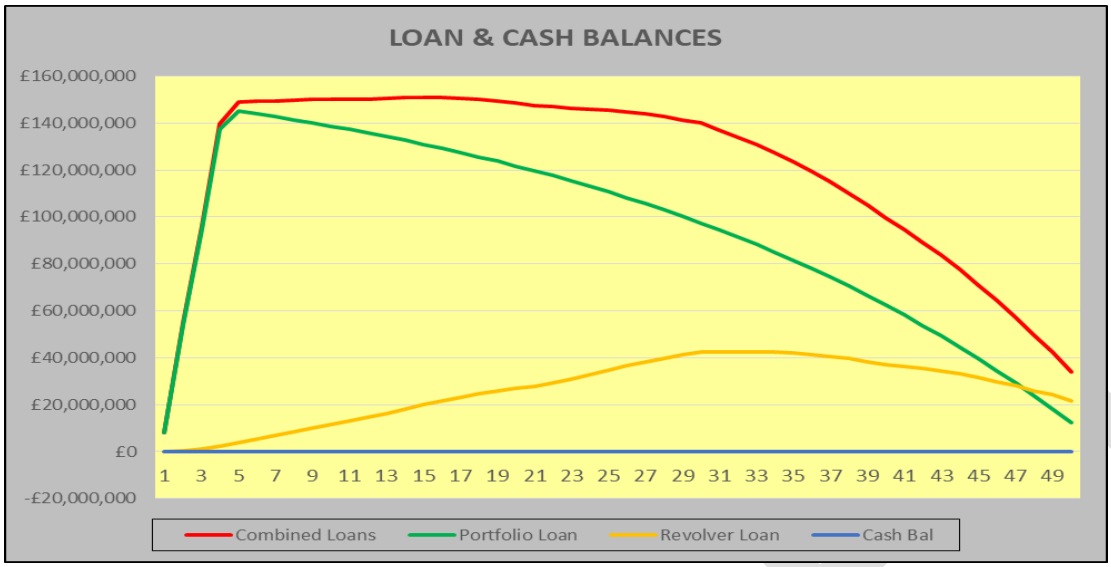
As we have previously discussed, the borrowing that ADC would draw from PWLB (or other sources) would have to be accounted for within the capital expenditure plans and increases the General Fund Capital Financing Requirement (CFR). In turn, this requires the section 151 officer to determine the level of Minimum Revenue Provision (MRP) to apply. If this is greater than zero, ADC would need to finance the MRP from the loan premium received. For example if MRP was set at 4% of loan balances (on the basis of a 25 year asset life, for example), this could be in the region of £6million per annum. The key here would be to develop a repayment and MRP strategy that was fundable from cashflows whilst also meeting the principles of prudence for the Council.

The chart below shows the financial position if 50-year annuity loans were drawn down by TL.

The green line represents the fixed loans and the scheduled repayment, whereas the yellow line demonstrates the additional working capital loan that would be required by TL in order to maintain positive cash balances. A combination of both loans is demonstrated by the red line, but full repayment could be achieved by year 54, as before.

A 15% cash equity injection of c£20.9million over the first 5 years would see a position of no working capital facility required, but would leave the council having to make MRP payments on this value (if it was borrowed) and a reduced interest premium from the on-lending.

Chart 5.3 – TL (LHC) - Forecast Loan Balances (Fixed Annuity Basis) – Blended Acquisition Approach



Therefore, the financing of the potential acquisition route for TL will need serious consideration by ADC.

Sensitivities and stress testing

We have modelled a range of sensitivities using the 'revolver' loan approach to test both positive and negative impacts upon the plan.

5.7 Option 3: TL (LHC acquisition) – Sensitivity Testing

Sensitivity	Debt in Year 50 £'m	Debt Repaid (Yr)	Cash Bal in Year 50 £m	Ave Interest Premium (Yr6) £'m
Base	**33.28**	**54**	**-**	**1.35**
Advantageous:				
Inflation 2.5%	-	47	40.17	1.36
Discount OMV 10%	-	49	6.94	1.27
100% Market Rent	24.23	53	-	1.48
Interest -0.25%	-	49	3.45	0.97
5% Equity Input	-	49	2.85	1.28
Rents +5%	-	49	7.18	1.34
No £2m C Tax Interest Restriction	-	47	27.57	1.34
50% Reduction in Acq No.s	-	50	0.91	0.68
Adverse:				
Inflation 1.5%	101.96	-	-	1.34
No OMV Discount	75.32	-	-	1.43
Interest +0.25%	78.42	-	-	1.73

Please note the sensitivity for reduction to 50% of acquisitions, in that financial viability is increased. This is due to a lower value of interest being charged and the impact of the £2million cap for corporation tax purposes, as exemplified in the sensitivity with it being fully withdrawn. However the net benefit to ADC is effectively halved.

Testing the plan we estimate that around 140 properties would be the minimum level of acquisition in order to cover overheads and the loans be repayable over a 50-year period from final acquisition.

The plan is however, very sensitive in general to changes in input economic, inflation and housing market assumptions

5.6. Meeting Objectives Assessment

As with the other options we have assessed a TL operating as a LHC through acquisition with the following objectives.

Table 5. 8 Option 3: TL (LHC acquisition) - Objective Matrix

Objective	Option Meets objective	Commentary
Ability to deliver the type of houses needed	No	No new developments controlled by TL/ADC will be built
Potential to provide Intermediate rented properties	Yes	Whilst TL (LHC) could deliver intermediate rented properties, this would be dependent on financial viability considerations
Provide a sound profitable basis	Yes	This is the most risk averse option. The plan shows no dividends as surpluses used for debt repayment

5.7. Advantages & Disadvantages

The advantages and disadvantages of through delivering through acquisition are detailed below:

Table 5.9 Option 3: TL (LHC acquisition) - Advantages and Disadvantages

Advantages	Disadvantages
The Council will make a return (premium) on the loans it makes to TL and the potential for dividends	VAT is payable on operating costs for TL.
Intermediate (if at LHA) rents – subsidised by market rents.	Additional running costs, board requirements and initial legal, financial and advisory costs to set up.
All properties classified as intermediate will be let on assured tenancies thus negating the loss of stock through Right to Buy	Potential implications for corporation tax, VAT, stamp duty land tax and State Aid (Subsidy Control)
Ability to flip rent levels for properties between intermediate and full market rent.	Additional administration with separate accounts required (that then possibly consolidate with the Council)
Market level rented properties could be sold or let as affordable rented properties at a later stage	The Council has no experience of letting within the private sector and will need to contract with a suitable provider.

5.8. Key Risks and Mitigation

The table below identifies the key risks specifically associated with the acquisition option.

Table 5.10 Option 3: TL (LHC acquisition) – Risks

Risk	Likelihood	Measures and mitigation
The financial assumptions used to model the outputs prove to materially different in practice	Medium	The assumptions will be undertaken with external advice and are comparable with other similar products. Variations would be appraised by the LHC board for it to instigate compensatory changes elsewhere in the plan or to monitor the situation if considered marginal.
Rising interest rates	Medium	Assumed increases will be built into the business case. In periods of higher inflation and interest rises living rents would be expected to increase. Fixed rate borrowing could also be undertaken.
Tax issues have not been clearly identified and modelled	Medium	Scheme appraisals will assume an allowance for payment of non-recoverable VAT. Advice needs to be sought as part of the set-up process to minimise future implications. Corporation Tax will be payable on annual profits.
A legal challenge is made with regards to State Aid (Subsidy Control)	Low	Expert opinion could be sought to ensure that the terms and interest rates offered on the loans by the Council are considered reasonable.
Properties prove difficult to let	Low	Demand through the waiting list shows that this should not be problematic for intermediate units. The ability to switch tenures if required.
Impact on staffing if the LHC is wound up or does not progress	Low	The assumption is that one member of staff is recruited to deliver the acquisitions. Other than this TL would not employ anyone directly and any services that could not be provided by the Council internally would be outsourced. Any support from the Council would use existing resources so there are no risks to current staff. Some support is anticipated to be outsourced within the modelling and this could be expanded
Perception and reputation	Low	The Council's role as an operator in the private letting sector would need to be considered in the context of ensuring correct branding and marketing strategy
Demand for certain tenures changes	Low	The balance of the properties, be it market rent or market sale, could be varied voluntarily for a short or medium term, though the impact to the business plan would be need to be assessed.

6. Developing a Way Forward

6.1. Summary

From reviewing the three options, both options 1 and 2 should, in our view, be discounted, in our opinion, on the basis of the relatively high risk associated with these options. This is discussed further below with the considerations required to progress with option 3.

Option 1

Whilst option 1 returns a profit for developing properties and provides the HRA with the opportunity to acquire 30% of whatever is built, TL (Devco) would be in competition with medium to large sized developers who have the immediate resources, designs and Supply chain, all of which bring cost efficiencies. Therefore, as shown in our example, TL (Devco) could easily be outbid for land acquisitions. Furthermore, as ADC does not have the resource or capacity in-house to provide to TL (Devco) this would have to be procured externally and this may be at risk. We also feel that uncertainties with both post Brexit and the Covid pandemic that material prices are subject to high levels of inflation and labour resources are low in terms of capacity would lead to uncertain levels of development costs, putting any potential profit or equity injection at risk.

Option 2

Due to the reliance on both development and land acquisition and the likely low levels of properties that could be retained for letting at market rents, the option for creating a subsidiary for TL is a route that is likely to be unviable. It cannot be completely ruled out if ADC opts to progress with option 3, with a substantial land holding, but would continue to carry the risk of upfront costs and loss of equity injection if land acquisitions were unsuccessful.

Option 3

The option for diverting away from development and focusing on acquisition is considered the lowest risk and potentially most financially viable option for Trisanto. This is primarily due to the much reduced costs involved in appointing an officer, either within TL or ADC (and subsequently recharged) to focus on acquisitions, but also the ability to test individually the viability of each acquisition to determine if it should go ahead or not.

The primary risk is that insufficient numbers of properties are able to be acquired in order to cover forecast overheads, and also gives unpredictability in terms of the funding requirement from ADC in order to inform the Medium-Term Financial Strategy. In addition, external tax advice will be required upon which both officers and members of ADC can rely, given the substantial impact this has on the viability of the plan.

Therefore, this is the one option that should be considered for further investigation and advancement to a full business case stage.

As we have commented, ADC can initially test the market with local agents, active developers and also researching auction sites to see whether sufficient properties could be acquired before committing a dedicated resource for TL.

ADC will need to consider the funding of TL in order to make these acquisitions and the associated debt repayment mechanisms to ensure viability.

It is likely that no dividends could be payable for a number of years if TL surpluses are utilised for loan repayments but ADC will benefit from the interest premiums on loans but also a shareholding in a company with of an asset base that will appreciate in value.

In addition, the 50-year potential repayment period would also need to be considered and a view taken on an appropriate hurdle for loan payback. Conversely, as a trading company, the Council may take the view that Trisanto may always have options to "trade out" and realise gains to repay borrowing.

We have provided our opinion on the treatment of both tax and meeting State Aid (Subsidy Control) requirements, but ADC may wish to seek further specialist legal advice on this before progressing.

Finally, before progressing we suggest that research is carried out to demand for both market and possibly intermediate rent within the district and if there are particular geographical area, property types or sizes upon which to focus.